Risk Management Bulletin

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Common Reporting Errors on Schedule CMR
And How to Avoid Them

The Office Of Thrift Supervision's (OTS) Net Portfolio Value Model can provide significant insight into how well thrift executives are managing interest rate risk, provided they accurately report their institution's exposures on Schedule CMR. Our experience suggests this does not always occur.

Provided below are some of the most common reporting errors that institutions make when filing Schedule CMR and a discussion of how these errors can be avoided.

1. **Failing to accurately self-report the value of borrowings and securities with embedded options.** If you have structured borrowings such as putable and callable FHLB advances or complex securities with embedded options, such as CMOs, callable Agency bonds and certain trust-preferred securities, the market value estimates of these instruments must be self-reported in the supplemental Reporting of Market Value Estimates section. Fill out this section of the schedule carefully. Typographical errors and missing values are by far the most common errors made on Schedule CMR. Also, make sure the numbers you report make sense. For instance, are the values going in the right direction?

2. **Failing to accurately distinguish between putable and callable FHLB advances.** In many cases, an institution will properly recognize the need to self-report structured FHLB advances but in doing so will use the wrong reporting codes. A putable advance (code 280) is one where the Federal Home Loan Bank has the option to demand early repayment. A callable advance (code 282) is one where your institution has the option to prepay the borrowing without penalty.

3. **Improperly classifying hybrid (3/1, 5/1/ 7/1, 10/1) mortgage loans.** Report hybrid mortgage loans with up to five years remaining until the next reset (e.g., 3/1 ARMs) as ARMs (CMR 141-CMR 245). Hybrid mortgages with more than five years until the next reset (e.g., 7/1 ARMs and 10/1 ARMs) should be reported as balloons (CMR096-CMR120). Finally, a 7/1 ARM that is more than two years old (less than five years remaining until reset) should be reported as an ARM.

4. **Reporting home equity loans and lines of credit as consumer loans**. Open-ended, revolving loans and home improvement loans secured by a single-family home (e.g. home equity loans) should be reported as second mortgage loans (CMR311-CMR319), not as consumer loans.

5. **Reporting money market mutual funds as equity securities.** Money market mutual funds should be reported as

"Cash, Non-Interest Earning Demand Deposits, Overnight Fed Funds, and Overnight Repos" (CMR461), not as Equity Securities (CMR464).

6. **Failing to specify the composition of mortgage-related mutual funds**. Institutions should use the Supplemental Reporting for Assets and Liabilities form if they have ARM mutual funds (reported on CMR464 and CMR584). This allows you to specify the asset composition of the mutual fund. Otherwise, the NPV model assumes that the fund consists of fixed-rate mortgages and MBS.

7. **Misreporting the maturity of construction loans-in-process (LIP).** Construction LIP represents the undisbursed portion of a construction loan. When reporting the maturity of LIP, use the date on which you expect to receive repayment of the construction loan. If the loan is a construction/ permanent loan, use the date on which the loan will be converted to permanent status, not the maturity of the permanent loan. Keep in mind that with a construction/ permanent loan, the permanent phase of the loan should be reported as a firm commitment to originate a mortgage loan, provided you have agreed to a particular interest rate.

8. **Misreporting the maturity of available-for-sale mortgages/ securities**. Available-for-sale mortgages/securities should be reported based on their contractual maturity (typically long-term), not their expected holding period. The price volatility of a particular loan or security is not affected by whether it is held-to-maturity or available-for-sale. If the thrift has a firm commitment to sell that security, still report it based on contractual maturity but also report the commitment under Financial Derivatives and Off-Balance-Sheet Positions. (The two should essentially cancel each other out.)

9. **Misreporting the maturity of floating-rate securities.** Report the maturity of floating-rate securities based on the next reset date, not the final maturity, in the appropriate category (government & agency, other investment securities, depending on the issuer). Institutions may also report these securities based on their contractual maturities and provide additional information regarding their floating rate features under Supplemental Reporting of Assets and Liabilities, but this approach is not required and may not necessarily lead to more accurate IRR estimates.

10. **Misreporting the coupon rate on municipal bonds**. When reporting the WAC on municipal bonds (Other Investment Securities (CMR479)), use the tax-equivalent-yield (yield/(1-tax rate)) rather than the nominal yield.

11. **Improperly adjusting for fallout on optional commitments to originate mortgages**. Optional commitments to originate mortgage loans should not be adjusted for fallout. The NPV model applies its own fallout estimate. (See section 7.B-1 of *The OTS Net Portfolio Value Model Manual* for more information on this topic.)

12. **Failing to distinguish between optional and firm commitments**. Many institutions fail to distinguish between optional and firm commitments. If you agree to originate, purchase or sell a mortgage loan at a specified interest rate within a specified period of time and the other party cannot walk away from the commitment without a substantial penalty or fee, the obligation should be reported as a firm commitment. If the other party can walk away without incurring a penalty the commitment is optional. Generally, if an institution collects a significant, non-refundable application fee prior to the loan closing, it's considered a firm commitment.

13. **Failing to treat commitments made on a best efforts basis as optional commitments**. Within the mortgage banking industry, many institutions will agree to purchase or sell mortgages on a best efforts basis. Best efforts means the holder of the option incurs no penalty for electing not to deliver/

purchase the specified product. Many institutions improperly treat these exposures as firm commitments and manually adjust the notional value for fallout. In actuality, these agreements are considered optional commitments that must be valued using an option pricing formula. Optional commitments to purchase or sell mortgages and MBS should be reported using codes 3002 through 3076. In reporting these positions, you must specify whether you are long or short the option. If your institution sells the option, it's considered a short position. Conversely, if it has purchased the option it's considered a long position. This is not as straightforward as it may seem. For example, if your institution has agreed to purchase, from a correspondent lender, a specified amount of 30-year mortgages, at a specified price, over a specified period of time on a best efforts basis, your thrift has actually sold an option. In other words, your institution has sold the correspondent lender the option to deliver the mortgages to your thrift if it so chooses. This exposure should be reported using code 3074 – short the option to sell 25-year or 30-year mortgages. Remember, optional commitments should not be adjusted for fallout.

14. **Reporting offsetting mortgage-banking exposures in which an institution, on a net basis, has no interest rate risk exposure.** In recent years, several institutions have entered into agreements with unaffiliated third parties, where the third party agrees to accept the interest rate risk associated with some or all of the loans in an institution's pipeline. A strict reading of the instructions would seem to suggest that an institution should separately report on Schedule CMR each particular transaction (e.g., the loan origination and the loan sale). In practice, however, OTS has been instructing institutions to refrain from reporting offsetting mortgage-banking transactions. In other words, if an institution has entered into two separate mortgage banking transactions that, when taken together, do not expose the institution to any interest rate risk, neither position should be reported on Schedule CMR. Before doing this, however, we strongly suggest that you check with your regional capital markets specialist.

The Office of Thrift Supervision will periodically update this list. In the meantime, if you are aware of other problems that we may have missed or if you want us to clarify any of the filing instructions, please feel free to contact your OTS regional capital markets specialist or send an e-mail to tfr.instructions@ots.treas.gov.

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